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March 9, 1993

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Office of the Secretary
Federal Communications
Commission
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Room 222
Washington, DC 20554

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Re: In The Matter Of
Simplification Of The
Depreciation Prescription
Process
CC Docket No. 92-296

TO THE HONORABLE COMMISSION:

Enclosed please find an original and nine copies of the
Comments Concerning Proposed Alternative Depreciation Options for
filing with the Commission in the above-referenced matter.

Please indicate your receipt of this filing on the
additional copy provided and return to the undersigned in the
enclosed self-addressed, postage prepaid, envelope. Thank you.

Sincerely yours,


Philip F. McClelland
Assistant Consumer Advocate

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UNITED STATES OF AMERICA
BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of :
Simplification of the :
Depreciation Prescription : CC Docket No. 92-296
Process :

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MAY 10 1993

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DISTRICT OF COLUMBIA OFFICE OF PEOPLE'S COUNSEL
FLORIDA OFFICE OF THE PUBLIC COUNSEL
INDIANA OFFICE OF UTILITY CONSUMER COUNSELOR
PENNSYLVANIA OFFICE OF CONSUMER ADVOCATE
COMMENTS CONCERNING PROPOSED DEPRECIATION OPTIONS

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DATED: March 10, 1993

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I. INTRODUCTION

The District of Columbia Office of People's Counsel, Florida Office of the Public Counsel, Indiana Office of Utility Consumer Counselor, and the Pennsylvania Office of Consumer Advocate, (hereinafter referred to as State Consumer Advocates or ("SCA")) file these comments concerning the Notice of Proposed Rulemaking on depreciation filings and other related matters (hereinafter referred to as Notice), released on December 29, 1992 by the Federal Communications Commission ("FCC" or "Commission") as Simplification of the Depreciation Prescription Process. Through this Notice, the FCC has proposed to revise the process by which depreciation expense is set. The Commission has requested the parties to "comment on proposals that would simplify procedures and reduce associated costs in our depreciations prescription process." Notice at ¶ 1. In the Comments which follow, SCA provide their views on the proposed depreciation methods.

II. SUMMARY

SCA are concerned that the FCC's proposed revision of current depreciation rules may very well significantly harm consumers and violate established depreciation principles. The lack of information and regulatory scrutiny encompassed within the options could well establish depreciation rates in excess of actual asset consumption. Most troubling in this regard would be the loss of the remaining life mechanism.

As the Notice indicates, the primary objective of determining depreciation for regulated carriers has been to "accurately allocate plant costs to expense at a rate representative of the actual consumption of the plant." Notice at ¶ 5. SCA are concerned that through the process of simplification, this objective may be compromised and depreciation expense set in excess of asset consumption. Depreciation is the largest component of total telephone company expense. Notice, Duggan St. at 2. While some simplification and administrative expense savings may be possible and advisable, any change which would significantly overstate depreciation expense would adversely affect consumers with little attendant benefit.

There are also more issues at stake in the depreciation process than simply the impact of depreciation expense on consumer prices. Telephone companies have vigorously argued that adequate levels of depreciation are necessary to insure the continued modernization of the network. Thus, if there is an inextricable link between the rates of depreciation allowed by the Commission

and the capital programs of the companies and the Commission releases the companies from the oversight of the depreciation process, then it also relinquishes its impact on the capital commitments of the companies to modernize the infrastructure. The Commission should carefully consider the effect on modernization before such a step is taken.

Depreciation expense has also become more difficult to set in recent years. Depreciation parameters are to a large extent not set based on currently experienced asset lives. Instead, depreciation is set based on present projections of asset lives based upon carrier deployment plans. These plans vary widely between carriers. The FCC should not simplify a process which so frequently involves subjective judgment if by doing so the data needed to resolve these complex issues is lost.

SCA recognize that the Price Cap system does not necessarily allow carriers to pass along all depreciation charges to the ratepayers. Depreciation is treated as an endogenous expense within a price cap system. Notice at ¶ 23. However, this principle does not mean that depreciation has no bearing on the ratepayers' rates. Carriers can indeed affect the overall cost to consumers based on their depreciation charge. The FCC made this point when it stated that:

since depreciation expense affects a carrier's earnings and, under certain circumstances, a carrier's earnings level will be used to determine the amount of sharing of excess earnings with ratepayers, the depreciation rates and the resultant expenses still have an important role under Price Cap regulation.

In the Matter of The Prescription of Revised Percentages of Depreciation pursuant to the Communications Act of 1934, 6 FCC Rcd 750 (1991). As Commissioner Duggan also stated in his Concurring Statement: "Changes in depreciation expense . . . can affect the price cap indirectly if the carriers are earning enough to be in the sharing zone, where they are obliged to share excess earnings with ratepayers through future reductions in the price caps. Carriers thus have the incentive . . . to manipulate depreciation expenses in order to avoid the sharing obligation." Notice, Duggan St. at 2. Therefore, "[e]ven for carriers under price caps, prescribing accurate depreciation rates is essential." Id.

SCA emphasize that continued use of the standard depreciation formula with its inherent remaining life adjustment process is important. The remaining life method has an established track record of calculating necessary revisions in order to reflect experienced service lives as an integral part of the represcription process.

SCA submit that the current three-way meeting process presents a workable means of addressing depreciation issues and ultimately operates largely through consensus. The depreciation rates established through this process by the Commission are most frequently the result of agreement between the affected parties, including the LECs, and ultimately implemented by Commission approval. Various state commissions, offices of consumer advocates and consumer counsels have participated in the three-way meeting process leading up to this type of depreciation agreement. Often

participants in the three-way meetings, including the LECs, reach agreement on these issues and adversarial adjudication before the FCC is not necessary. The record does not demonstrate that the agreements reached by participants in the three-way meeting process would be improved by the current proposed rulemaking.

SCA submit that the current study process has already been streamlined and automated to a great extent and the quality of the analysis has markedly improved. If the usual trend of reduced cost through improved data processing is any indication, the cost of the required studies should be lower in the future. SCA suggest the emphasis should be on making the current study process more efficient rather than reducing the depth or scope of the studies. SCA are concerned that adoption of any of the four proposals aimed at reducing the cost of the depreciation process could actually undermine the accuracy and fairness inherent in the current represcription process.

It would be extremely difficult to devise any generic rule that would properly set depreciation rates given the great number of factors which impinge upon the process and must be considered. Accordingly, SCA do not believe that it is essential to revise the depreciation process. If, however, the Commission decides to approve new rules governing depreciation methods, SCA recommend that the FCC adopt Option One, the Basic Factor Range Option, for a portion of all accounts. The accounts to which Option One would apply would be those for which there is little variance in service lives and dispersion patterns between carriers

and are not greatly affected by the various technology and service driven capital deployment plans proposed by different carriers.

SCA also recommend that for any option the FCC ultimately selects, carriers still should be required to maintain detailed continuing property records for their accounts. This is important particularly if the experimentally implemented revisions are not entirely successful. By maintaining these records carriers still would have the data to reproduce more detailed depreciation studies in the future and apply them to their plant accounts.

Finally, expensing salvage and cost of removal could simplify the depreciation process considerably and reduce workload. Issues surrounding expensing salvage and cost of removal will need to be addressed regarding its feasibility. Specific comments on this plan are presented later in these comments. Salvage and cost of removal require projections far into the future and are very difficult to project given a changing market for developing technologies. Accordingly, it would be appropriate to remove these issues from the depreciation process and reflect salvage and cost of removal on a more current basis.

III. INTEREST OF SCA IN THE PROPOSED REGULATIONS

The members of SCA are designated representatives of public utility consumers in three states and the District of Columbia. As the FCC is now proposing to promulgate regulations which could have a direct and substantial effect on the rates of telecommunications carriers nationwide, SCA have significant interest in this area.

IV. PRESENTATION OF COMMENTS

A. The Necessity For Simplification Advocated By The Industry Is Overstated.

The Commission discusses the need for simplification of the depreciation process in the Notice. Notice at ¶¶ 7-8. SCA, as parties to cases which set rates governing the majority of local exchange carrier revenues, are acutely aware of the magnitude and scope of data filed with depreciation studies. The fact that extensive data is needed to complete an appropriate depreciation study, however, is not in itself an indication that the depreciation process needs simplification. The latter conclusion can flow only from a determination which compares the importance of the data and analysis presented in a depreciation study and the costs of compiling and presenting that data and analysis. When this comparison is properly made, SCA believe that the need for simplification of the depreciation process by the industry is overstated.

First, the savings that allegedly would result from the simplification of the depreciation process are overstated. The Notice recites estimates of \$35-\$50 million in total savings for the industry. Notice at ¶ 8, fn. 9. The sources and methods used in these calculations should be rigorously scrutinized by the FCC. While the SCA are unaware of all the assumptions used in producing these figures, we believe that the USTA figure (\$35 million) assumes that all LEC personnel working in the depreciation field perform no work other than depreciation, and that all depreciation

work would cease if a "simplified" process were adopted by the FCC. Neither assumption is correct.

It is the experience of the SCA that carrier personnel working in the depreciation field provide substantial information to other employees for both accounting and tax purposes. This function would not be eliminated as a result of any action by the FCC in this docket, and thus not all the associated "expense" could be eliminated. Furthermore, substantial depreciation work would need to continue even if a simplified depreciation process were adopted by the FCC.

Substantial amounts of data collection and analysis will need to continue for both internal corporate purposes and to ensure that the books and records of the company are accurate. This is especially important in light of the Commission's observation that:

[C]arriers would be required to maintain their continuing property records regardless of the reviewing process we ultimately adopt. Continuing property records, records of the companies' plant investment, are necessary for accurate accounting records.

Notice at ¶ 22, fn. 17.

It is emphasized that any carrier operation must consider the consumption of underlying assets whenever it examines various business alternatives. Depreciation will be an integral part of these functions whether or not such information is submitted for regulatory purposes. Thus, the assumption in the USTA's calculation that all depreciation expense could be avoided by FCC action is incorrect.

Moreover, it must be remembered that simplification of the depreciation process at the federal level may not equate to such simplification of the process at the state level. States are perfectly free to set their own depreciation rates for plant under the state's jurisdiction. Louisiana Public Service Comm'n v. F.C.C., 106 S. Ct. 1890 (1986). As long as states still require that such rates be set on the basis of traditional depreciation studies, the savings postulated cannot materialize. Thus, even if those savings would actually exist in the absence of depreciation studies, the FCC has no ability to guarantee that such studies will not be needed.

At the same time, it is important to recognize that, even if the savings associated with the simplification of depreciation procedures could be realized and were not overstated, those savings are insignificant in the larger picture of telephone company revenue and expenses. For example, 1991 revenues of AT&T, Alascom, and the 33 local exchange carriers for which the F.C.C. prescribes depreciation rates were in excess of \$100 billion. Savings of the magnitude alleged by the USTA and the Council on Competitiveness, even if correct, amount to only about .04-.05% of revenue. These savings are so small that they would never be reflected in rates to customers, regardless of whether the carrier was subject to price-cap or rate of return regulation. If the savings will not serve to reduce rates to ultimate end-users, SCA see little point in giving up the availability of useful depreciation information.

It is the general view of the SCA that the benefits of the information contained in full depreciation studies far exceed the cost savings that would be achieved by eliminating the studies. Although this is particularly true for carriers regulated on the basis of rate of return, it is clear that carriers operating under price-cap regulation also have an incentive to manipulate their depreciation expense. Even though such expense is an endogenous variable not directly affecting the price-cap index, as noted above Commissioner Duggan correctly pointed out in his Statement that changes in depreciation can affect price cap sharing. Notice, Duggan St. at 2. The sharing mechanism is a key part of the consumer protections established under the price cap plan for local telephone companies and should not be undermined. Id.

All these factors lead the SCA to conclude that the Commission should "go slow" with respect to any attempts to streamline the depreciation process. The benefits of simplification to consumers are minimal or nonexistent, and the potential for harm resulting from inadequate review of this major expense category is great. It is for this reason that the signatories have concluded that, if the FCC does undertake simplification of the depreciation process, contrary to SCA's recommendation, changes should be limited to the proposal specified in the Basic Factors Range Option; and that option only should be applied to certain accounts.

B. Option One - Basic Factor Range Option - Is the Most Preferable Of The Options Considered.

SCA submit that Option One, Basic Factor Range Option, is the most preferable option considered, but only for selected accounts. Through this Option, ranges for accounts using Option One would be established for the basic depreciation parameters by account, e.g. projection life, survivor curves, future net salvage. Rates would still be calculated through the standard remaining life formula and applied to the account balances. The remaining life adjustment process would remain.

Establishment of the factor ranges should depend on industry-wide data as the FCC has tentatively concluded. Notice at ¶ 14. SCA concur that one standard deviation above and below the average would appear to be a workable method. Id. This method would allow a reduction in administrative effort and some savings because detailed studies would not be required by the FCC for the accounts selected.

SCA submit that this method or any of the others proposed should not be used for 'major' categories of investment, or for those categories that historically have displayed sufficient variability in factors or parameters to warrant more detailed data analysis. Instead, Option One treatment may be applied to the depreciable plant whose projected survival characteristics most closely parallel historic experience and do not significantly vary between carriers. Examples which may be acceptable in this area would be the following accounts: 2112, Motor Vehicles; 2113,

Aircraft; 2115 & 2116, Work Equipment; 2122, Furniture; 2123, Office Equipment; 2424, Submarine Cable; and 2441, Conduit.

Current more detailed FCC represcription procedures should continue to apply to the other accounts where the setting of depreciation parameters requires a more detailed study of actual experience and projections. Where one carrier plans on a comprehensive rebuild of its network while another is not prepared to make such a commitment, it would be unreasonable to allow each to choose freely from the same depreciation factor range. The selective use of Option One would allow the FCC Staff and other parties to devote the majority of their review to the other accounts which contain a majority of the plant investment and are more difficult to analyze and forecast.

The three-year represcription process still should be used for accounts which require detailed studies. Thus, the carriers would prepare the standard depreciation study including development of projection lives, survivor curves, and future net salvage based on an analysis of historical data and/or expected trends for the future. The range of basic depreciation parameters for the Option One accounts presumably already would have been chosen by the FCC. As part of the preparation for represcription, the carrier would select depreciation parameters for the Option One accounts within the FCC specified ranges. Next the carriers would calculate depreciation rates based on the average remaining lives for all accounts (both detailed and Option One) and apply these rates to the current account balances to calculate the proposed

depreciation expense. This complete package of information still should be presented at the three-way meeting for discussion.

Option One should be implemented for all companies on their normal, staggered three-year study cycle. The initial (linear) phase-in should allow three years for the company to meet factor ranges in the selected accounts (after starting the process on a normal cycle). In this way, a 33% adjustment from current rates would be allowed per year. This would be necessary as the remaining life adjustment technique may be in the process of correcting for changes due to actuarial data or assumptions, and some time may be necessary for this to flow through. The three-year phase-in would provide the recovery period for transition. Further, carriers must not be able to change their selected basic factors more than once a year.

Basic factors should be reviewed with industry data by the FCC at least once every five years. Any longer period presents risks of failing to properly set depreciation rates because of rapid business and/or technological changes affecting some or all of the company's plant accounts.

SCA concur with the FCC conclusion that depreciation changes should continue to be considered an endogenous change under price cap regulation. Notice at ¶ 24. As the Commission intends, Option One would continue to reflect actual asset consumption. Accordingly, the same discussion set forth in the Notice concerning the LEC Price Cap Order would still apply. Notice at ¶ 23. Particularly as Option One will still reflect the remaining life

formula, it is appropriate to consider such depreciation changes as endogenous.

SCA are concerned with the continued use of ELG relative to Option One accounts. If actual retirement dispersion is changing, ELG procedures can cause significant errors in matching accruals to plant consumption. This can be held to a minimum if the depreciation parameters are reviewed frequently. Normally the 3-year review cycle would resolve the concern. For this reason we suggest that the review by the FCC of the basic factors be performed every 3 years for accounts using ELG.

LECs and IXC's should be considered in separate groups because of differences in their operating characteristics as the FCC tentatively concluded. Notice at ¶ 15. For example, digital switches for AT&T or MCI perform higher level toll switching functions than LEC equipment. LEC switches, while they perform some toll switching, are built primarily to provide dial tone and local switching functions. The markets served and the services provided by these company groups are different. Therefore, we expect that over time these factors will create differences in service lives and dispersion patterns for the accounts of the two groups.

Additional savings might be obtained by allowing all affiliated carriers to select basic factors within the ranges on a regional basis (Ameritech - five states, GTE North - seven states, etc.). The common depreciation rate would then be applied to the individual state account balances for all affiliated

companies within a region. Many of the companies seem to manage their capital procurement on a regional basis. Continuing LEC consolidation efforts have resulted in their engineering, planning, and operations focusing on regional, rather than state criteria. It is, however, important to continue to recognize that between regions important differences continue. For example, poles are more susceptible to ice storms and insects in the midwest than on the west coast potentially causing shorter lives. SCA suggest a regional approach would be appropriate but caution in going beyond any regional approach.

C. SCA Oppose The Use Of Option Two - Range Of Rates Option, As Well As Option Three - Depreciation Schedule Option.

1. Option Two - Range Of Rates Option

a. Introduction.

SCA oppose the use of the Range of Rates Option - Option Two. Option Two would allow carriers to apply depreciation rates without any continued application of the remaining life formula. Notice at ¶¶ 26, 31, 32.

Loss of the remaining life formula would allow depreciation rates to be applied without any reference to the actual consumption of the assets to which they are applied. Without any analogous "true-up mechanism" it would be possible for a carrier to depreciate more than 100% of an asset. This type of depreciation unrelated to asset consumption must be rejected.

b. Remaining Life.

The Commission has recognized that the remaining life depreciation method is useful as a means of revising depreciation rates in order to recover any depreciation reserve deficiency or surplus over the remaining life of an asset. Amendment of Part 31, 83 FCC 2d 267, ¶¶ 76-84 (1980). The Commission has described the use of remaining life as a method necessary to avoid "the possibility that our prescribed rates would be based on large errors in forecasting asset service lives and net salvage values." Modification of the Commission's Depreciation Prescription Practices, 4 FCC Rcd 8567, ¶ 4 (1989).

SCA support the continued use of remaining life in order to make certain that depreciation expense continues to be adjusted as a result of actual asset retirement. As the Commission recognized in the Orders indicated above, it is essential that some type of mechanism be set in place that will continue this type of adjustment function.

c. No Revision To The Remaining Life Adjustment Is Necessary.

The remaining life system continues to function well in order to make sure that asset consumption and depreciation rates remain consistent. The principle problem with Option Two is the loss of the remaining life function.

SCA are most concerned with any mechanism that may fail to match asset consumption with depreciation recovery. The Notice considers this problem in view of the possibility that carriers may potentially not depreciate "100% of plant costs." Notice at ¶ 31.

It is quite possible that, if a range of depreciation rates may be applied by carriers with no clear matching between depreciation rates and actual asset consumption, carrier assets may be depreciated more than once on their books of accounts thus permitting more than 100% recovery. Given the FCC emphasis on simplification, it is difficult to see how this goal would be met by devising yet another true-up mechanism which may then require more regulatory oversight to make certain that it is correctly applied.

The Notice at ¶ 32 requests comments as to whether some other type of "true-up mechanism" should be adopted in conjunction with Option Two. The reason for the present existence of the remaining life mechanism at the FCC was a reaction to depreciation reserve imbalances that had grown under previous depreciation systems. SCA see no reason to discard the present remaining life system in favor of yet another "true-up mechanism" when none is needed. Given the risk that some other undefined mechanism will not work as well as that which is presently in place - and given the potential size of depreciation expense problems which may arise from an inadequate recovery mechanism - such a further depreciation method revision should be rejected.

Loss of the remaining life feature may also threaten the endogenous price cap treatment of depreciation expense now in effect. Notice at ¶ 23. Depreciation rates set in accordance with the remaining life method will be based upon actual net book plant values and will automatically recover any reserve imbalances. Thus,

the remaining life method supports the Commission assumption that prescribed depreciation rates are actually determined by carrier retirements. Id. In the absence of remaining life, the FCC may then be required to periodically determine how depreciation reserve imbalances must be amortized as a depreciation related expense. The effect of such amortization on the price cap mechanism is not clear. However, SCA are concerned that the loss of the remaining life mechanism and the necessary substitution of an alternative true-up mechanism could threaten the present endogenous treatment of depreciation expense.

d. Conclusion

Primarily as a result of concerns with the loss of the remaining life mechanism, SCA oppose Option Two. If the FCC determines that Option Two should be applied, the means of implementing Option One advocated by SCA above should be applied to Option Two as well. Any such application of Option Two should apply a true-up mechanism at least as efficacious as the remaining life method.

2. Option Three - Depreciation Schedule Option

SCA also oppose the use of Option Three, Depreciation Schedule Option. This Option would require the Commission to set a single service life, retirement pattern and salvage value for all carriers. Notice at ¶ 33. This Option offers a great degree of simplification but also "the greatest deviation from accuracy in matching allocation of costs with plant consumption." Id.

Much of the reason for opposing this Option relates to the same problems noted above with regard to the recovery of imbalances. The FCC notes that "because this option ultimately provides for 100% depreciation of the costs of plant, the potential for an imbalance is merely temporary, not permanent like that which could occur under the rate range option." Notice at ¶ 39. Nonetheless, the FCC would have to monitor the imbalance occurring for each carrier and then determine what changes to depreciation expense may be necessary in order to recover those imbalances.

As noted above, this reinvention of a true-up mechanism that performs a role similar to that of remaining life is unlikely to simplify the depreciation process. One can well imagine successive iterations of recovery mechanisms which could linger for years in order to properly amortize any depreciation imbalance that may occur. This injects an added degree of uncertainty into the depreciation process which is now largely avoided.

Equally troubling is the "one size fits all" approach of this method. Regardless of the recognized differences between carriers in their existing depreciation parameters, Option Three applies the same depreciation schedule to all. What is most certain about Option Three is that this approach is sure to result in further imbalances.

For these reasons SCA oppose Option Three. If the FCC applies this Option the same mechanisms advocated above with regard to Option One should also apply.

D. The FCC Should Not Implement Option Four - The Price Cap Carrier Option.

1. Introduction

SCA strongly urge the Commission not to approve the Price Cap Carrier Option, Option Four, because of the legal and policy problems associated with it.

Option Four would no longer require price cap carriers to be subject to any meaningful review before the FCC concerning their depreciation rates. The FCC would require the carriers to provide the following information: depreciation rates in effect, proposed depreciation rates, and the changes in depreciation expense that would be experienced if the proposed rates would become effective. Notice at ¶ 41. As the Notice clearly states, "[t]his option would essentially eliminate all of the steps the Commission now takes to analyze the carriers' proposed depreciation rates." Id. The review process would occur by publication of the proposed depreciation rate changes and Commission review of any comments submitted before determining the reasonableness of the proposed changes. Id.

2. It Is Unlawful To Set Depreciation Rates Without A Factual Record.

Carriers cannot set their own rates for service, yet this is the practical effect of proposed Option Four. Under the FCC's governing statute, the FCC must approve carriers' proposed depreciation rates. See 47 U.S.C. § 220.

The FCC's approval process must be based upon facts. Without the requirement that carriers supply certain fundamental

depreciation information, the FCC would not have a record on which to base its depreciation rates decisions. A fundamental tenet of administrative law requires that agency decisions must be based in fact; otherwise, they will not withstand judicial scrutiny. See e.g., Citizens to Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402 (1971) (requiring court to consider whether relevant factors were considered and whether there has been a clear error of judgment); FCC v. Nat'l Citizens Committee for Broadcasting, 436 U.S. 775, 793 (1978) (FCC has considerable general rulemaking authority, "so long as [its] view is based on consideration of permissible factors and is otherwise reasonable"); see also Connecticut Light & Power Co. v. NRC, 673 F.2d 525, 530-01 (D.C. Cir.), cert. denied, 459 U.S. 835 (1982) (agency must disclose data upon which a proposed rule is based). The U.S. Supreme Court has held that "the agency must examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made." Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Automobile Ins. Co., 103 S.Ct. 2856, 2866-67 (1983). An agency must present an adequate basis and explanation for its decisions. Id. at 2862.

Although the courts are highly deferential to agencies when reviewing agency decisions, the decision must at least have a rational basis grounded in fact. See Environmental Defense Fund v. Costle, 657 F.2d 275 (D.C. Cir. 1981) (affirming agency decision where rational basis for agency action is present in record and agency engaged in reasoned decisionmaking based on consideration of